No. 18-457

In the Supreme Court of the United States

NORTH CAROLINA DEPARTMENT OF REVENUE,
Petitioner,

v.

THE KIMBERLEY RICE KAESTNER 1992 FAMILY TRUST,
Respondent.

On Writ of Certiorari to the North Carolina Supreme Court

BRIEF FOR CERTAIN STATE TRUST AND BANK ASSOCIATIONS AS AMICI CURIAE IN SUPPORT OF RESPONDENT

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TABLE OF CONTENTS

TABLE OF AUTHORITIES iii

STATEMENT OF INTEREST OF AMICI CURIAE 1

SUMMARY OF ARGUMENT 2

ARGUMENT 3

I. A DISCRETIONARY BENEFICIARY LACKS SUFFICIENT CONNECTION TO THE ASSETS OF A TRUST TO PROVIDE A JURISDICTIONAL NEXUS 3

A. A Discretionary Beneficiary Has No Present or Future Ownership Interest in the Trust 6

i. A Discretionary Beneficiary Neither Controls Nor Owns Trust Property ... 7

ii. A Discretionary Beneficiary Has No Expectancy of Future Ownership of Trust Property 10

B. The State Provides No Benefits to the Trustee or for the Assets Held in Trust . 12

II. NORTH CAROLINA'S APPROACH TO TRUST TAXATION IS UNUSUAL AND UNCONSTITUTIONAL 14

A. North Carolina's Statute and Other Single-Factor Tax Analyses are Unusual and Contrary to National Standards of Fairness 15

B. Courts Have Not Upheld Taxation Based on a Single-Factor Analysis 18

III. THE NORTH CAROLINA SUPREME COURT DECISION PROTECTS FUNDAMENTAL RIGHTS 21

A. Upholding the North Carolina Supreme Court Decision is Consistent with Federalism and Due Process 21

i. Federalism and State Sovereignty Require the Balance the Respondent Seeks 21

ii. Application of 14th Amendment Protections Prevent Petitioner's Position 23

B. Sound Tax Policy is Preserved Between and Among the Federal Government and State Governments by Upholding the North Carolina Supreme Court 25

C. Administrative Burdens Would be Overwhelming if the North Carolina Supreme Court were Overturned 28

CONCLUSION 33

TABLE OF AUTHORITIES

Cases

Anderson v. Wilson,
289 U.S. 20 (1933) 6

Appeals of Yolanda King Family Trust and Mary L. Tunney Jr. Trust I,
Nos. 357825, 357829, 2007 Cal. Tax LEXIS 406
(State Bd. Equalization of Ca. Oct. 4, 2007) . . . 17

Asahi Metal Indus. Co. v. Superior Ct. of Cal.,
480 U.S. 102 (1987) 24

Am. Trucking Ass'ns v. Smith,
545 U.S. 429 (2005) 32

Brooke v. Norfolk,
277 U.S. 27 (1928) 3, 7, 8

Burger King Corp. v. Rudzewicz,
471 U.S. 462 (1985) 14

Chase Manhattan Bank v. Gavin,
733 A.2d 782 (Conn. 1999) 20

Complete Auto Transit, Inc. v. Brady,
430 U.S. 274 (1977) 31, 32

Comptroller of Md. v. Wynne,
135 S. Ct. 1787 (2015) 31

Conn. Gen. Life Ins. Co. v. Johnson,
303 U.S. 77 (1938) 22

Dows v. Chicago,
78 U.S. 108 (1870) 21

Fielding v. Comm'r of Rev.,
916 N.W.2d 323 (Minn. 2018) 19

Greenough v. Tax Assessors of Newport,
331 U.S. 486 (1947)..... 6, 7, 22

Hanson v. Denckla,
357 U.S. 235 (1958)..... 24

International Shoe Co. v. Washington,
326 U.S. 310 (1945)..... 24

Kulko v. Superior Ct. of Cal.,
436 U.S. 84 (1978)..... 24

Linn v. Dep't of Revenue,
2 N.E.3d 1203 (Ill. App. Ct. 2013) 19

Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.,
439 U.S. 299 (1978)..... 25, 28

McCulloch v. Franchise Tax Board,
390 P.2d 412 (Cal. 1964)..... 20, 21

McCulloch v. Maryland,
17 U.S. 316 (1819)..... 22

McNeil v. Pennsylvania,
67 A.3d 185 (Pa. Comm. Ct. 2013) 19

Nichols v. Eaton,
91 U.S. 716 (1875)..... 9

Quill Corp. v. North Dakota,
504 U.S. 298 (1992)..... 23

O'Hayer v. De St. Aubin,
30 A.D.2d 419 (1968) 4

In re Pugh,
274 B.R. 883 (Bankr. D. Ariz. 2002) 9

Safe Deposit & Trust Co. v. Virginia,
280 U.S. 83 (1929)..... 8

South Dakota v. Wayfair,
138 S. Ct. 2080 (2018)..... 2, 23, 28, 31

In re Swift,
727 S.W.2d 880 (Mo. 1987)..... 19

Westfall v. Director of Revenue,
812 S.W.2d 513 (1991) 19

Constitutions, Statutes and Regulations

11 U.S.C. §§ 541(a), 541(c)(2) (2018)..... 9

ALASKA STAT. § 13.36.080(b) (2018)..... 30

CAL. REV. & TAX CODE §§ 17742, 17745(c),
17745(b) (Deering 2019)..... 17

CONN. GEN. STAT. § 12-701 (2018)..... 16

12 DEL. CODE ANN. § 3303 (2019) 30

FLA. STAT. § 736.0306 (2018)..... 30

GA. CODE ANN. §48-7-22(a)(1)(C) (2018) 15

GA. COMP R. & REGS. 560-7-3-.07(3)(b) (2018) 15

I.R.C. §§ 1, 61, 301, 641, 641(b), 651-652,
661(a), 662(a), 671-679, 701-702, 6012(b)(4),
2031 (1986) 4, 7, 10, 26, 27, 29

Minn. Stat. § 290.01, subd. 7b (2018) 31

N.H. Rev. Stat. Ann. Section 564-B:1-105 (2017).. 31

N.Y. TAX LAW §§ 605(b)(3)(B)-(C), 605(b)(3)(D)(I), 612(b)(40) (2019) 17, 18

NEV. REV. STAT. § 163.004 (2019) 30

N.C. GEN. STAT. § 36C-5-502(c), 36C-5-504(a)(2), 36C-5-504(b), 36C-8-810, 36C-8-815, 36C-8-816(15), 55-15-01 et seq., 105-160.2 (2018) 7, 8, 9, 18, 29

S.D. CODIFIED LAWS § 55-2-13 (2018) 30

Sup. Ct. R. 37 1

Sup. Ct. R. 37.6. 1

TENN. CODE ANN. §§ 35-15-813, 67-2-102, 67-2-110(a) (2018) 15, 31

U.S. Const. amend. XIV 22, 23, 28

Other Authorities

I.R.S., *Instructions for Form 1041* (2018) 27

Clara Penniman, *State Income Taxation* (1980) 26, 27

Richard D. Pomp, *State & Local Taxation* (8th Edition 2015) 26

Restatement (Second) of Trusts, §§ 2, 155(1) & cmt b, 170(1), 175 & cmt. f, 186 (1957) 7, 8

Restatement (Third) of Trusts §§ 2, 44, 49, 50, 70, 78(1), 100, 103, 104 (2003) 4, 5, 6, 7

Revised Model Business Corporation Act § 15.05 (ABA Bus. Law Section 2016) 25

Peter Spero, *Updated Analysis State Taxation of Out-of-State Trusts*, 46 Estate Planning 20 (April 2019) 32

Subchapter J — Throwback Rules, Est. Gifts & Trusts (BNA) 856-2nd. 17

Tenn. Dep't of Rev., Notice #17-09 (May 2017), *https://www.tn.gov/content/dam/tn/revenue/documents/notices/income/income17-09.pdf* .. 15

Unif. Law Comm'n, Trust Code, https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d 8

Uniform Trust Code §§ 810, 815, 816(15) 7, 29

STATEMENT OF INTEREST OF AMICI CURIAE[1]

Pursuant to Supreme Court Rule 37, six professional associations, dedicated to serving the growing interest in each of their respective states and across the nation in professional trust administration, respectfully submit this brief of amici curiae in support of Respondent. Amici curiae consist of the South Dakota Trust Association, New Hampshire Trust Council, Estates and Trusts and Taxation Sections of the Delaware Bar Association, Nevada Trust Company Association, Delaware Bankers Association, and Tennessee Bankers Association (together, the "Trust Associations").

Each Trust Association serves as the professional and trade association for its respective state's trust industry by promoting, educating, and supporting the professionals, judiciaries, legislatures, clients, and organizations engaged with trusts and trust management. Each of the Trust Associations strives to enhance its members' ability to be preeminent providers of fiduciary and trust services for families not only in their respective states, but also located throughout the country and world, while also

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[1] In accordance with Supreme Court Rule 37.6, the amici curiae state that no party other than amici, their members and their counsel have made a monetary contribution to fund the preparation and submission of this brief. Neither counsel for the Parties nor the Parties were involved in any way in this brief, to include by participation in its preparation or in the funding thereof. Both Parties have filed letters granting blanket consent to the filing of amicus briefs.

furthering the interests of its respective state and its citizens and, in turn, the continuous establishment and refinement of the statutory, regulatory, and judicial landscape affecting trusts and trust companies.

This brief will endeavor to assist the Court in considering the practical and administrative implications of the issue, particularly with respect to discretionary trusts and their management.

SUMMARY OF ARGUMENT

The question before the Court is whether the single fact of a resident discretionary beneficiary gives North Carolina the right to tax the accumulated income of an out-of-state trust.

In this case, the issue is not whether North Carolina may tax a beneficiary on trust distributions, but instead whether North Carolina may tax undistributed income in a trust with no ties to North Carolina other than a discretionary beneficiary residing in the state.

This case presents an important question relating to historic trust jurisprudence and its application consistent with other taxable entities. This Court's holding in *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018), altered but did not eliminate minimum nexus thresholds. Reversal of the decision of the North Carolina Supreme Court in this case would eliminate such constitutional standards, to the detriment of the orderly administration of state and federal tax systems.

Established law on the taxation of discretionary trusts, including the law of Petitioner (North Carolina), clearly proves that the residence of a discretionary

beneficiary does not provide sufficient nexus for the imposition of income taxes by a state on the trust's worldwide income. The decision of the North Carolina Supreme Court and the prior precedent of this Court do not create "a judicially created tax shelter" as Petitioner contends, because current law concerning the taxation of trusts and beneficiaries ensures no such abuse occurs. The constitutional and policy concerns addressed in this brief, as well as the practical impact of accepting the Petitioner's position, demonstrate that the Court should reject Petitioner's arguments and uphold the decisions below.

ARGUMENT

I. A DISCRETIONARY BENEFICIARY LACKS SUFFICIENT CONNECTION TO THE ASSETS OF A TRUST TO PROVIDE A JURISDICTIONAL NEXUS

In an attempt to create a connection between the State and the income the State wishes to tax, North Carolina has based its taxation of a trust on a beneficiary's residence and, by doing so, disregards the meaningful distinction between a trust and its beneficiary. Resolution of this issue before the Court, then, in large part, turns on what a trust is and what a trust is not. To conflate a trust with its beneficiary is to disregard basic tenets of trust law, especially where distributions of income and principal are subject to the discretion of its fiduciary. This Court has previously rejected this notion, *see, e.g.*, *Brooke v. Norfolk*, 277 U.S. 27, 29 (1928), and the Court should once again reject it here.

A beneficiary of a discretionary trust[2] has no rights to or expectancy of a distribution of the trust assets. Respondent ("Kaestner Trust") is such a discretionary trust because the trustee has complete discretion over trust distributions (subject to an implied obligation of good-faith, as required by New York law, e.g. *O'Hayer v. De St. Aubin*, 30 A.D.2d 419 (1968), which governs this Trust) and the ultimate power to determine what distributions, if any, will be made. Resp't Br., at 3; Joint App., at 46, 62 (§§ 1.2, 5.8(a) of the Kaestner Trust).

The terms of a trust establish the rights and obligations of the parties. A trust creates a fiduciary relationship by agreement between a transferor of certain property (the settlor[3]) and one or more persons (the trustee or trustees) who receive and hold legal title to that certain property for the benefit of one or more others (beneficiaries). Restatement (Third) of Trusts § 2

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[2] Going forward, the term "discretionary trust" shall refer to a trust such as Respondent, the terms of which (1) grant trustees complete control over whether to make distributions from the trust, and (2) do not cause taxation of income to its settlor under Internal Revenue Code ("I.R.C.") §§ 671-679, the "Grantor Trust" rules. The term could be appropriately applied to a broader range of trusts, but for purposes of illustrating the arguments central to this brief, the term will be limited in its meaning unless otherwise specified. The term "discretionary beneficiary" will be used to refer to a beneficiary of a discretionary trust.

[3] The words "settlor," "donor," "trustor," and "grantor" can be interchangeable, and typically refer to the creator of a trust. This brief will use the word "settlor" to reflect the prevalent term used in North Carolina trust law, the state of the statute under scrutiny.

(2003). A trust is the product of its settlor's wish to transfer an interest in property to or for someone else, subject to particular conditions established by the settlor. The trust terms are a legal agreement reached between settlor and trustee (and not beneficiary) and set conditions that the settlor attaches to the property, as well as the duties to which the trustees must adhere. The trust beneficiary's rights are circumscribed by the trust terms. Restatement (Third) of Trusts § 49 (2003). A trustee is charged with duties and granted powers and rights over trust property to carry out those duties; a beneficiary has no rights over the trust property other than those expressly conferred to him or her under the terms of the trust, Restatement (Third) of Trusts § 50 (2003), and, in turn, owes no duty or obligation to the trustee or trust.[4]

While all trusts exist with reference to three constituencies – settlor, trustee and beneficiary[5] (the "trust triad") – in the case of a discretionary trust, the relationship between trust and beneficiary is especially remote. As the following sections will explain, a

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[4] A beneficiary generally has no personal liability to the trust, Restatement (Third) of Trusts § 104 (2003), nor to third parties for obligations incurred by trust or trustee, Restatement (Third) of Trusts § 103 (2003), and only becomes liable to the trust or related third parties such as through debt or malfeasance involving trust or trustee. In fact, a trust may be created without definite beneficiaries. Restatement (Third) of Trusts § 44 (2003).

[5] Note, a trust can exist without a beneficiary, for example a non-charitable purpose trust which has no beneficiaries and instead its sole purpose is to care, protect and/or preserve an asset, or trusts created without definite beneficiaries at the onset. Restatement (Third) of Trusts § 44 (2003).

beneficiary of a discretionary trust fundamentally lacks sufficient rights over the property of that trust for the contacts of that beneficiary to be imputed to the entire trust.

A. A Discretionary Beneficiary Has No Present or Future Ownership Interest in the Trust

Before creating a trust, the settlor holds both the legal title to and beneficial interests in the property with which she will fund the trust. As owner of that property, she is free to enjoy the property and manage it in her interests, including consuming, using, gifting or donating the property. But in transferring it to trust, the settlor severs benefit from control: she confers the benefit in that property to the trust beneficiaries, but grants exclusive legal rights and control over that property to the trustee. Restatement (Third) of Trusts § 2 (2003); *Greenough v. Tax Assessors of Newport*, 331 U.S. 486, 494 (1947). The beneficiary does not have any legal title to the trust assets, as the trustee is the legal owner. *See, e.g.*, *Anderson v. Wilson*, 289 U.S. 20, 24 (1933). Further, the interest held by a discretionary beneficiary does not and cannot exhibit any indicia of ownership to justify disregarding the trust's structure by equating the beneficiary with the trust.

i. A Discretionary Beneficiary Neither Controls Nor Owns Trust Property

All control over trust assets is vested in the trustee alone.[6] It is a trustee's duty alone to take and keep exclusive control of trust property. *See* Restatement (Second) of Trusts, §175 & cmt. f (1957). A beneficiary has no control over trust assets. This is fundamental to the nature of a trust.[7]

Every U.S. jurisdiction that imposes a tax on trust income recognizes a beneficiary's lack of control over trust assets because it is the trustee, not the beneficiary, who must file a tax return and pay any tax due by the trust. For example, the North Carolina statute at the center of this controversy specifically directs that the trustee "shall pay the tax" imposed on a trust by that part. N.C. GEN. STAT. § 105-160.2. Section 6012(b)(4) of the Internal Revenue Code of 1986, as amended ("I.R.C."), similarly directs that

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[6] By extension, a trustee – and not the beneficiaries – is liable for any losses incurred as a result of trustee's breach of trust in the management of trust assets. Restatement (Third) of Trusts § 100 (2003); *see also Greenough*, 331 U.S. at 494; *Brooke v. Norfolk*, 277 U.S. 27, 29 (1928).

[7] A trustee's powers are set by the terms of the trust and by local law, and generally include the full breadth of powers necessary to manage trust assets and administer the trust. Under the Uniform Trust Code § 815 and North Carolina General Statutes § 36C-8-815, the trustee may exercise all general powers to achieve the proper management and administration of trust property. *See also* Restatement (Third) of Trusts § 70 (2003); Restatement (Second) of Trusts § 186 (1957).

returns of a trust "shall be made by the fiduciary thereof," that is, by the trustee.

This Court has long recognized that control reflects ownership, from which it follows that, as the sole party in control, the trustee of a trust is the owner of trust assets. *See e.g.*, *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83, 92 (1929); *see also Brooke v. Norfolk*, 277 U.S. 27, 29 (1928). Beneficiaries of a discretionary trust have no control over assets held by the trust through their status as beneficiaries, and not only lack legal title, but also lack any legally recognized property interest in the trust property.

Many areas of law recognize a discretionary beneficiary's lack of a property interest in a trust. For example, under both state and federal law, a discretionary beneficiary's creditors generally cannot reach the assets of the trust.[8] North Carolina is representative of many states that have codified this principle by adopting the Uniform Trust Code and its provisions regarding creditor claims.[9] The North

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[8] Restatement (Second) of Trusts § 155(1) & cmt b (1957); *but see* note 11, *infra*; N.C. GEN. STAT. § 36C-5-504(b) (2018) (examples of instances in which the creditors of a discretionary beneficiary *could* reach trust assets.) Such instances where a discretionary beneficiary's creditor could reach trust assets arise under unique circumstances that are far beyond the fact pattern in this case.

[9] A version of the Uniform Trust Code (UTC) has been adopted by 34 states and the District of Columbia. *See* Unif. Law Comm'n, Trust Code, https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d (last visited Mar. 22, 2019). Article Five of the UTC is consistent

Carolina Uniform Trust Code specifically provides that "a creditor or assignee of a beneficiary may not reach a discretionary trust interest." N.C. GEN. STAT. § 36C-5-504(a)(2), (b) (2018). It is not surprising that all of the courts in North Carolina that considered Petitioner's arguments refused to find that the beneficiaries had any ascertainable interest under local law giving rise to a jurisdictional nexus over the trust.

Ms. Kaestner's interest in the trust would not even constitute property in a bankruptcy estate. Pursuant to 11 U.S.C. § 541(a) (2018), a debtor's bankruptcy estate is comprised of "all legal and equitable interests of the debtor in property at the commencement of the case." Because Ms. Kaestner cannot transfer her interest in the trust,[10] her interest would not be part of her bankruptcy estate. 11 U.S.C. § 541(c)(2) (2018); *see also In re Pugh*, 274 B.R. 883, 885 (Bankr. D. Ariz. 2002). Further, North Carolina precludes creditors from reaching such interests. N.C. GEN. STAT. § 36C-5-502(c) (2018). This Court has long found similarly. *See e.g., Nichols v. Eaton*, 91 U.S. 716, 724 (1875).

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with the foregoing description of North Carolina law and reflects a concept prevalent throughout trust law.

[10] In many states that restriction is codified into law, e.g. N.C. GEN. STAT. § 36C-5-504(b) (2018), and some trusts, such as the Kaestner Trust, specifically prohibit a beneficiary from transferring his or her interest. Joint App., at 70 (Article TWELFTH of the Kaestner Trust). Whether or not that prohibition is codified, the fact remains that a beneficiary has no mechanism for transferring an interest in a discretionary trust (nor even an identifiable interest to attempt to transfer).

Recognition that a discretionary beneficiary owns no assets of the trust is not limited to the creditor context. Federal and state income tax laws respect that a discretionary beneficiary is not the owner of trust property by taxing the trust, and not the beneficiary, on income earned and retained by the trust. I.R.C. § 641. Similarly, at the death of a discretionary beneficiary, trust assets are not included among her assets subject to estate taxes. I.R.C. § 2031. North Carolina's attempt to tax the trust in this case is directly at odds with these principles.

ii. A Discretionary Beneficiary Has No Expectancy of Future Ownership of Trust Property

A discretionary beneficiary does not own trust property and, importantly, may never own any trust property. In their amicus brief in support of Petitioner, Stephen Feldman *et al.* claim that "only a trust's beneficiary is entitled to trust income." Brief for Law Professors as Amicus Curiae, supporting Petitioner, at 2, 7. That statement is misleading. In fact, a discretionary beneficiary has no entitlements unless granted to him or her by the trust terms, and is not entitled to income as a matter of course. Income of a discretionary trust may be used to pay expenses or taxes, added to principal, or ultimately distributed to a different beneficiary. Thus while a discretionary beneficiary *may* receive property at some point in time, such beneficiary has no legally recognized expectancy of ownership and is certainly not entitled to receive trust property in a given tax year or any year.

The Kaestner Trust is a discretionary trust. Pet'r's Br., at 3. As with discretionary trusts generally, the trustee's control extends beyond trust management to decisions over distributions to beneficiaries – when, to which beneficiaries, of how much, and critically, whether to make any distributions in the first place. Pet'r's Br., at 3. The beneficiary has no legal right to receive trust income or principal, or enforceable expectancy of receiving it in the future. Brief for the American College of Trust & Estate Counsel as Amicus Curiae, supporting neither party ("ACTEC Br."), at 7. In fact, a discretionary beneficiary could pass away without ever receiving a distribution from the trust. A discretionary trust beneficiary has no discernible right to trust assets, because all power to make (or not make) distributions is vested in the trustee, who is authorized under the terms of the trust agreement to make no distributions at all.

In the trust context, the word "benefit" (and by extension, beneficiary) is a term of art: to say that trust property must be held "*for the benefit of*," Restatement (Second) of Trusts § 2 (1957); Restatement (Third) of Trusts § 2 (2003), one or a class of beneficiaries is not an affirmative statement describing a benefit to be received by such "beneficiaries," but should be read in the negative, to mean that trust property must not be held with the intent to benefit *anyone else* outside of the designated class.[11] Although the terms of a

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[11] Among a trustee's fiduciary duties is the duty of loyalty, requiring that the trustee administer the trust solely in the interest of the beneficiary. *See e.g.* Restatement (Second) of Trusts, § 170(1) (1957); Restatement (Third) of Trusts, § 78(1) (2003).

particular trust may confer affirmative, appreciable benefits upon a beneficiary, a discretionary trust grants no such benefits to a beneficiary absent an act of the trustee. A discretionary beneficiary has neither a present property interest in, nor an expectancy of future ownership of, trust property unless and until a trustee makes a distribution from the trust to the beneficiary. If and when a trustee chooses to make a distribution from a discretionary trust, the beneficiary receiving such distribution will have the distributed property in hand and it will have ceased to be trust property.[12] Thereafter, the property is owned by the beneficiary and thus taxable to the beneficiary.

B. The State Provides No Benefits to the Trustee or for the Assets Held in Trust

A number of briefs in favor of Petitioner contend that the Trustee or the assets held in the Kaestner Trust benefit directly from the services and protections North Carolina offers to the trust beneficiaries. They assert that the trust would be required to deplete trust assets in the absence of the services the State provides to the resident beneficiaries (as well as all residents of North Carolina). *See, e.g,* Pet'r's Br., at 17, 31; Brief for Minnesota, Nineteen Other States & the District of Columbia as Amicus Curiae, supporting Respondent ("Minn. Br."), at 15-16. This argument is misdirected for a number of reasons, two in particular. First, it disregards the fact that the Kaestner Trust is a

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[12] Furthermore, under I.R.C. §§ 661(a) and 662(a), the beneficiary (and not the trust) will be subject to taxation on the share of trust income carried out to him or her through the distribution.

discretionary trust, and second, it relies on contacts that are too remote and attenuated.

The trustee of the Kaestner Trust has no obligation to make any distributions to a trust beneficiary, whatever the purpose. Were there a shortfall in state services from which beneficiaries suffered, the trustee would be under no obligation to distribute trust assets to fill that gap. Similarly, the Trustee may make a distribution to provide a beneficiary with services in addition to those provided by the state. For example, North Carolina offers public education to its residents but the trustees of the Kaestner Trust have discretion to distribute (or refuse to distribute) funds to send a North Carolina-resident beneficiary to private school. As this illustrates, there is no essential relationship between the services and protections North Carolina offers to its residents and the trustee's obligation (or lack thereof) to make distributions to beneficiaries.

The North Carolina resident beneficiaries moved into the state of their own accord (or were born there, as the case may be). The beneficiaries are appropriately taxed in North Carolina on their income like all state residents and in turn have access to the same resources as other residents. A discretionary beneficiary's unilateral choice of residence – and unilateral benefit from that residence – does not reflect a benefit to a trust, and cannot reasonably be used to tie a discretionary trust to a beneficiary's state of residence.[13] The trust, on the other hand, did nothing

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[13] Unilateral activity of a third party, claiming a relation to the nonresident party, cannot satisfy this requirement of contacts with

to direct itself towards North Carolina, as the trustee did not seek or rely on any benefits from the state.

Petitioner erroneously claims that the Kaestner Trust directed itself towards North Carolina's "sound local banking institutions" in making a loan to Ms. Kaestner. Pet'r's Br., at 36. Had the trust loaned money to an independent third party living and banking in a third state, it arguably would have benefitted similarly from that state's banking institutions, but such benefit would not have caused the worldwide income of the trust to be subject to income tax in that state. The straws Petitioner grasps for, in an attempt to weave a colorable argument of sufficient connection with the State, are simply non-existent and unable to pull all trust assets into Petitioner's taxing net.

II. NORTH CAROLINA'S APPROACH TO TRUST TAXATION IS UNUSUAL AND UNCONSTITUTIONAL

Petitioner and its amici argue that upholding the decision of the North Carolina Supreme Court would impact the trust taxation regimes of a myriad of states and throw state taxation of trusts, and state revenue therefrom, into disarray. Pet'r's Br., at 39-43. That is simply not the case. The North Carolina trust taxation statute is not only at odds with the Constitution, but also an outlier among state trust

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the state; instead, the actual party must purposefully avail itself of the privileges of acting within the state and of the benefits and protections of the state's laws. *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 474-76 (1985).

taxation statutes. Any trust taxation statute based on a single factor analysis is unusual, and, where that single factor involves solely the residence of a settlor or beneficiary, is inadequate to establish constitutionally sufficient connection.

A. North Carolina's Statute and Other Single-Factor Tax Analyses are Unusual and Contrary to National Standards of Fairness

Contrary to Petitioner's assertion, the North Carolina trust taxation statute is an outlier. Pet'r's Br., at 6. Of the 51 jurisdictions in the United States, only North Carolina and Georgia[14] take the position that a discretionary beneficiary residing in the state *may* subject the trust to taxation in that state. GA. CODE ANN. §48-7-22(a)(1)(C) (2018); GA. COMP R. & REGS. 560-7-3-.07(3)(b) (2018).

Every other state that considers a beneficiary's residence in taxing trusts applies a multi-factor analysis to determine whether a trust is subject to tax in that state. Without seeking to comment on the constitutionality of either, the Connecticut and California trust taxation statutes offer two examples of multi-factor analyses that consider residency of beneficiaries – but critically, take other factors into

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[14] Tennessee had previously employed a similar tax system, see TENN. CODE ANN. §§ 67-2-102, 67-2-110(a) (2014), but is amending their law and will no longer tax income (of trusts or otherwise) on this basis, as of 2021. Tenn. Dep't of Rev., Notice #17-09 (May 2017), *https://www.tn.gov/content/dam/tn/revenue/documents/notices/income/income17-09.pdf.*

account as well. Also without comment on their constitutionality, the California and New York statutes illustrate another approach to taxation based on beneficiary residence, imposed on previously untaxed income upon distribution to such beneficiary. All such statutes point to the superficiality and inadequacy of Petitioner's approach by providing a level of analysis that is lacking in the North Carolina statute.

The Connecticut trust taxation statute defines a "resident trust" with reference to the settlor's state of residence, and only taxes resident trusts on the trust's worldwide income. CONN. GEN. STAT. § 12-701 (2018). If a resident trust has a noncontingent beneficiary that resides outside of the State, Connecticut will tax only the resident noncontingent beneficiaries' proportionate share of the trust income. *Id.* Even if Ms. Kaestner moved to Connecticut, her residency would never suffice to cause the Kaestner Trust to be taxed under the Connecticut statute because it is a fundamentally nonresident trust. Notably, a beneficiary's residence comes into play only after consideration of settlor's residence, and only then in the case of a noncontingent beneficiary; the beneficiary's residence is also not sufficient to cause the trust to be considered "resident" to Connecticut, as that is defined based on the settlor.

California presents an interesting example because, though often cited as a state that taxes trusts based upon the residence of a beneficiary, it in fact takes a much more nuanced approach. Like Connecticut, California requires that the resident beneficiary upon whom trust taxation is based be one with a "non-contingent" interest, that is, in California's conception

not a discretionary beneficiary. CAL. REV. & TAX CODE § 17745 (Deering 2019). If a trust only has discretionary beneficiaries resident in California, the trust will not be subject to tax in California as a result of the beneficiaries' residence. CAL. REV. & TAX CODE § 17745 (Deering 2019); *Appeals of Yolanda King Family Trust and Mary L. Tunney Jr. Trust I*, Nos. 357825, 357829, 2007 Cal. Tax LEXIS 406 (State Bd. Equalization of Ca. Oct. 4, 2007).

California also imposes a "throwback" tax on a discretionary beneficiary, but not the trust, see CAL. REV. & TAX CODE §§ 17742, 17745(c), 17745(b), which is a reflection of historic U.S. tax law on trusts that was repealed in 1997. *Subchapter J — Throwback Rules*, Est. Gifts & Trusts (BNA) 856-2nd, at I.B. The current California statute states that "if no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent, such income shall be taxable to the beneficiary *when distributed or distributable to him or her*." CAL. REV. & TAX CODE § 17745(b) (Deering 2019) (emphasis added). In other words, California delays its tax until the element of discretion is resolved—when the beneficiary has the distribution in hand and the connection between trust property and beneficiary is certain. Still, it is the *beneficiary* that is subject to the eventual tax, not the trust.

New York also incorporates a throwback tax on resident beneficiaries. New York generally determines the residency of a trust with reference to the residence of its settlor, but other factors are also considered. N.Y. TAX LAW § 605(b)(3)(B)-(C) (2019). New York

taxes the worldwide income of resident trusts, but also creates an exemption for trusts with no New York trustees, assets or source income. N.Y. TAX LAW § 605(b)(3)(D)(i) (2019). New York imposes no tax on a trust as a result of beneficiaries' residence, whether contingent or noncontingent; instead, it taxes the accumulated income of a New York resident trust only upon receipt by a New York beneficiary. N.Y. TAX LAW § 612(b)(40) (2019).

The North Carolina statute, by contrast, simply taxes income of a trust that is "for the benefit of a resident of" that state, N.C. GEN. STAT. § 105-160.2, and from the way it was applied to the Kaestner Trust, it is clear that the State declines to infer any nuance from that instruction. In applying its statute, North Carolina disregards the myriad of other factors that establish a trust's contact with states, and paints all beneficiaries – even beneficiaries with exceedingly remote contacts to a trust, who may never benefit from trust property – with one broad brush; this application obscures the immense variety that can be accommodated by that term.

B. Courts Have Not Upheld Taxation Based on a Single-Factor Analysis

Petitioner cites a number of state court opinions as justification for the North Carolina statute. Examination of these cases, however, illustrates the state statutes under consideration were materially different from North Carolina's. Nevertheless, the reasoning in these other state court cases further illuminates that a single-factor analysis for imposing taxation is simply insufficient.

Numerous states have found that multiple factors need to be considered in order to find sufficient connection for the state to constitutionally tax the trust's entire worldwide undistributed income. *See, e.g.*, *Fielding v. Comm'r of Rev.*, 916 N.W.2d 323, 332-33 (Minn. 2018); *Linn v. Dep't of Revenue*, 2 N.E.3d 1203, 1210 (Ill. App. Ct. 2013); *McNeil v. Pennsylvania*, 67 A.3d 185, 194-95 (Pa. Comm. Ct. 2013)(Commerce Clause); *In re Swift*, 727 S.W.2d 880, 882 (Mo. 1987); *Westfall v. Director of Revenue*, 812 S.W.2d 513, 514 (1991). Lessons derived from three states, in particular, are illustrative of the necessity to employ a multifactor analysis when evaluating the taxation imposed on a trust's accumulated income.

In Pennsylvania, the State attempted to tax a trust's income based on the residence of a beneficiary. The attempt was rejected. In *McNeil v. Pennsylvania*, the court found it was unconstitutional to tax a trust on its earned income and capital gains with no other connection to the state other than the grantor's residence at the time the trust was established and the residence of the discretionary beneficiary with no current or future rights to the trust assets. *McNeil*, 67 A.3d at 198. The State of Pennsylvania asserted the same argument as the Petitioner: the settlor and the discretionary beneficiaries benefited from the state's legal framework, which "in turn" benefitted the trust whose purpose was to support the beneficiaries. This argument was rejected by the Pennsylvania court because the beneficiary was not the taxpayer and the trust did not directly benefit from the state's protections or benefits, including the state's roadways,

bridges, fire protection, economic markets or access to courts.

Connecticut also attempted to tax a trust's accumulated income. In *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), the court was asked to consider Connecticut's trust taxing statute, which is not a single-factor statute. Connecticut's statute only imposes a tax on an inter vivos trust if it is a "resident trust" which is defined as a trust that became irrevocable when the settlor was a domiciliary. Petitioner's brief misrepresents the holding of *Gavin*. Connecticut's statutory law allows for a reduction—not the imposition—of taxes if non-contingent beneficiaries live outside of the state. In *Gavin*, the only current beneficiary was domiciled in Connecticut and had current mandatory rights to income and ultimately principal—as opposed to a discretionary beneficiary as in the present case. Therefore, the holding in *Gavin* is that if the only current beneficiary of a trust who is entitled to mandatory income is domiciled in Connecticut, the trust is not able to claim a reduction. This holding does not assist Petitioner.

California's jurisprudence also supports a multifactor analysis to taxing a trust's accumulated income. Petitioner cites *McCulloch v. Franchise Tax Board*, 390 P.2d 412 (Cal. 1964) as central to Petitioner's argument, but it is clearly distinguishable. Pet'r's Br., at 30, 33. First, the *McCulloch* court was concerned with California's throwback tax, discussed above, and not the taxation of a trust based on beneficiary residence. Second, in *McCulloch*, the trust had a resident trustee (incidentally, the beneficiary in

question). Third, and most importantly, in *McCulloch*, the California beneficiary had received a terminating distribution and thus had all trust assets in hand, cementing the connection between assets and beneficiary. *McCulloch*, supra, at 188. Petitioner's attempts to apply *McCulloch* to connect a discretionary beneficiary to a trust fail because the *McCulloch* court did not have to make that connection: Mr. MuCulloch's connection to the trust was plainly evidenced by his receipt of all trust assets. That cannot be said of any of the beneficiaries of the Kaestner Trust.

The statutes and cases described above illustrate the importance of a multifactor analysis to evaluating the "residency" of a trust, and that many states are already moving in this direction. They also illustrate the importance of rejecting a single-factor approach to taxing trusts.

III. THE NORTH CAROLINA SUPREME COURT DECISION PROTECTS FUNDAMENTAL RIGHTS

A. Upholding the North Carolina Supreme Court Decision is Consistent with Federalism and Due Process

i. Federalism and State Sovereignty Require the Balance the Respondent Seeks

Federalism balances the sovereignty of the states with the power of the federal government. States have always had the power to levy taxes in order to raise their own revenue, independent of the Federal government. *Dows v. Chicago*, 78 U.S. 108, 110 (1870).

However, the state taxing power is not boundless; a state's power to tax is necessarily constrained by the Fourteenth Amendment. *Conn. Gen. Life Ins. Co. v. Johnson*, 303 U.S. 77, 80 (1938). The decision of the North Carolina Supreme Court does not infringe on a state's valid exercise of sovereign power; rather, it gives effect to the boundary between the outer limit of state sovereignty and the constitutional guarantees of the Due Process Clause. *See also Greenough*, 331 U.S. at 497.

Petitioner selectively relies on the Court's opinion in *McCulloch v. Maryland*, 17 U.S. 316 (1819), for the proposition that the "states' authority to tax is a cornerstone of federalism," Pet'r's Br., at 19, but ignores the limitations of federalism set by the same court with respect to a state's power to tax. To read *McCulloch v. Maryland* as endorsing the use of federalism to obscure deficiencies in a state tax scheme, as Petitioner appears to do, is to overlook the opinion's strong language describing the "paramount character of the Constitution" such that the Constitution "may restrain... a State from such [exercise of its taxing power]... as is in its nature incompatible with, and repugnant to, the constitutional laws of the Union." *McCulloch v. Maryland*, 17 U.S. at 425.

Rejecting the North Carolina statute is not a rejection of the principles of federalism, but rather a recognition and endorsement of the outer boundary of state sovereignty to tax, compatible with "the constitutional laws of the Union," *McCulloch v. Maryland*, 17 U.S. at 425, which is the very aim of federalism.

ii. Application of 14th Amendment Protections Prevent Petitioner's Position

Upholding the decision of the North Carolina Supreme Court serves to defend not only the aims of federalism, but also the protections of the Due Process Clause consistent with existing standards of taxation, broadly. The defense of both requires the rejection of Petitioner's position.

Recent decisions of this Court have sought to update Commerce Clause jurisprudence with respect to state taxation in light of technological and societal changes that have unfolded in the time since seminal decisions were written.[15] However, no technological or societal changes have broken down distinctions among the components of the trust triad to justify such a drastic deviation from precedent regarding trusts.

Under the Due Process Clause as applied to state taxation, there must be a definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax, and the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state. *Quill*, 504 U.S. at 306-07. The minimum contacts analysis of

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[15] The Court's opinion in *South Dakota v. Wayfair* rests, in part, on reconsidering Commerce Clause precedents interfering with the State exercise of sovereign powers and recognition of the deficiencies of the Commerce Clause analysis in *Quill* in a contemporary setting. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2088-89, 2092 (2018); *Quill Corp. v. North Dakota*, 504 U.S. 298, 306-07 (1992).

International Shoe Co. v. Washington, 326 U.S. 310 (1945), as articulated in *Hanson v. Denckla*, 357 U.S. 235, 253 (1958), to include the requirement of purposeful availment, and as further developed in subsequent cases, is applied to determine whether the minimum connection exists for the state to assert its taxing authority over a given taxpayer. *Int'l Shoe Co.*, 326 U.S. at 316; *Hanson*, 357 U.S. at 251; *Kulko v. Superior Ct. of Cal.*, 436 U.S. 84, 92 (1978); *Asahi Metal Indus. Co. v. Superior Ct. of Cal.*, 480 U.S. 102, 108-09 (1987). Because a trust, through its trustee, is that taxpayer, the use of state contacts of a discretionary beneficiary in asserting tax jurisdiction over the trust's accumulated income distorts the longstanding distinctions of the trust triad.

No matter the taxpayer, no matter the activity, the measure for the constitutional nexus depends on the quality and nature of the activity in relation to the fair and orderly administration of the applicable tax law. *Int'l Shoe*, 326 U.S. at 319. An important analogue is found in the treatment of corporations. Corporations can and should expect to be taxed on activities that occur in the place of their incorporation (akin to where they reside) and also in the place(s) where they purposefully maintain property, hire employees or agents, or generate sales, but states do not exert taxing authority over corporate earnings based on the residence of the shareholders prior to the payment of dividends. Even then, it is the shareholder that is taxed on the dividend received, not the corporation.

The Revised Model Business Corporations Act, on which North Carolina's Business Corporations Act is

based, N.C. GEN. STAT. § 55-15-01 et seq. (2018), sets forth a framework for evaluating whether a foreign corporation is considered to be transacting business in the state; the statute expressly excludes loaning and borrowing funds and maintaining bank accounts from being considered sufficient activities causing a foreign corporation to be considered to have transacted business in the state. Revised Model Business Corporation Act § 15.05 (ABA Bus. Law Section 2016). These activities are excluded from consideration for purposes of North Carolina corporate tax on foreign corporations, N.C. Gen. Stat. § 55-15-01, and similar activities conducted by a nonresident trustee should be similarly viewed as excluded activities in the analogous context of income taxation of trusts.[16]

B. Sound Tax Policy is Preserved Between and Among the Federal Government and State Governments by Upholding the North Carolina Supreme Court

The federal and state tax compliance systems include adequate measures to capture the economic activities of trusts and ensure tax compliance by trusts without resorting to the tenuous approach applied by the North Carolina statute under scrutiny. Trusts have many points of contact with state and federal systems of taxation, and only one such point is at issue

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[16] In the bank regulatory context, a national bank chartered in one state that extends credit to residents of another state, even if such residents were systematically solicited, will not be considered to be "located" in the non-charter state. *Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 311 (1978).

in this case – state taxation of accumulated trust income.[17] That the state most naturally positioned to do so does not levy an income tax on a trust neither authorizes another state to do so absent sufficient contacts of its own, nor transmutes the trust from reasonable legacy planning vehicle into an evasive one.

Federal income taxation of trusts is addressed in I.R.C. Subchapter J. The trustee of a trust must report the trust's activities on a fiduciary income tax return unique to the trust, I.R.S. Form 1041, on which the trust reports its income, claims its own deductions and calculates its own, separate federal tax liability, which the trustee must pay. I.R.C. § 6012(b)(4). I.R.C. Section 641(b) provides that "The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual ... [and] ... [t]he tax shall be computed on such taxable income and shall be paid by the fiduciary." That is, a trust avoids none of the stringent reporting (and payment) requirements to which individuals are subject.

States that tax trusts apply similarly stringent requirements to trusts. State systems vary but commonalities exist, as well as consistencies, with the federal system because states have largely mirrored the general approach to taxation adopted by the federal government. Richard D. Pomp, *State & Local Taxation*, at 10-2 (8th Edition 2015) *citing* Clara

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[17] Assets transferred by a living settlor to a discretionary trust are subject to gift tax, or if transferred as a result of the settlor's death, to estate tax; income earned by a trust is uniformly subject to federal income tax.

Penniman, *State Income Taxation*, at 2, tbl. 1 (1980). Like the federal government, states have two opportunities to tax trusts: taxing income accumulated in a trust with constitutionally sufficient contacts to that state, and taxing income distributed out of the trust to an in-state beneficiary. I.R.C. §§ 661(a), 662(a) (illustrating the framework also employed in applicable state statutes).

Like partnerships, and to ensure that all relevant parties (fiduciaries, beneficiaries, and federal and state governments) receive consistent tax information, a trustee must report any distributions made from the trust (and any income and other economic factors carried out from the trust with distributions) on Schedule K-1 to its fiduciary income tax return(s). I.R.S., *Instructions for Form 1041*, at 36 (2018), https://www.irs.gov/pub/irs-pdf/i1041.pdf. This requirement ensures that if trust assets change hands from trustee to beneficiary, all tax attributes are accounted for. Collectively, these reporting requirements and the tax obligations that follow ensure that income does not escape taxation by virtue of being earned by a trust: the timing of that income tax may vary from the result that would have obtained had the income-producing property been held by an individual, and the applicable taxing statutes may also differ, but the trust is transparent to taxing authorities and held to account. Trusts are not tax shelters.

To reverse the North Carolina Supreme Court decision and allow tax on the accumulated but undistributed income of a trust that may never be distributed to a beneficiary in that state would be

inconsistent with the policy and extensive procedures of our federal and state income tax systems.

C. Administrative Burdens Would be Overwhelming if the North Carolina Supreme Court were Overturned

In determining whether the statute passes constitutional muster, the analysis of fundamental fairness required by the Fourteenth Amendment must consider the practicalities of the application of the statute given the "present realities" of trust administration. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080, 2097 (2018). In practice, the fiduciary management of trust assets would become untenable if the North Carolina statute is found to be constitutional and other states were to amend their statutes to follow suit. Trustees of trusts with large beneficiary classes and geographically mobile beneficiaries would struggle with uncertain tax obligations in multiple states. This lack of clarity would make tax compliance impossible, or lead to gross noncompliance, and upend trust administration in ways that have previously been viewed as undesirable by this Court.[18]

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[18] In the context of bank regulation, this Court has declined to expand the definition of a bank's "location" in recognition of the confusion that would be caused by requiring banks to consider whether they are located in a state based solely on certain contacts with residents of that state. *Marquette Nat'l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 312 (1978).

Under the statute in question, the trustee "responsible for administering the [ ] trust shall pay the tax computed." N.C. GEN. STAT. § 105-160.2 (2017). The State of North Carolina and a minority of other states, Minn. Br., at 4, 6, 9, are asking this court to reach a conclusion that focuses on the beneficiaries, but would enforce the conclusion solely against the trustee. The powers given to a trustee do not allow the trustee to obtain the information necessary to comply with a statute that taxes based on the residency of a discretionary beneficiary. A trustee has the right to obtain information related to a trust's income and applicable deductions.[19] The trustee also has the power to pay such taxes with trust property.[20] However, a trustee does not have the power to compel beneficiaries to provide the information needed to determine their residency. Even if the trustee was able to obtain the addresses of a beneficiary, many individuals are mobile or have multiple residences. Further, the determination of an individual's residency can be a multi-factor test based on objective and subjective

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[19] In fact, it is the trustee's duty to maintain the records that would contain such information. Uniform Trust Code § 810 and North Carolina General Statutes 36C-8-810 state that a trustee "shall keep adequate records of the administration of the trust." See Uniform Trust Code § 810 (Unif. Law Comm'n 2010), N.C. GEN. STAT. § 36C-8-810 (2018).

[20] It is the trustee's duty to file trust tax returns, see I.R.C. § 6012(b)(4), and accordingly the trustee is empowered to pay trust taxes. See Uniform Trust Code § 816(15) (Unif. Law Comm'n 2010) and N.C. GEN. STAT. § 36C-8-816(15) (2018), both granting trustees power to pay from trust property taxes incurred in administration of trust.

factors. As a result, the trustee would still be lacking information necessary to determine residency for tax purposes.

The facts presented in this case are rare in that the current discretionary beneficiaries all resided in a single state for a period of time. It is a far more common situation that beneficiaries are in multiple states and move between states. A trustee may not even know of a beneficiary's place of residence. As beneficiaries are not required to provide a trustee necessary information for the trustee to make a determination on residency, the trustee does not possess the power to practically administer a trust under a state that requires such analysis for compliance by a trustee.

Trustees may even be prohibited from seeking the information necessary in the context of trusts known as "quiet trusts," which authorize the trustee to withhold information from the trust beneficiary or may even prohibit the trustee from providing information to the trust beneficiary. Quiet trusts are permissible under the laws of certain states that permit designated representatives to represent and bind the trust beneficiaries, thus limiting a beneficiary's rights to be informed of the nature of the beneficiary's interest in the trust and limiting a trustee's ability to communicate with beneficiaries of such trusts. Quiet trust statutes are typically found in jurisdictions with advanced and modern trust law. *See* S.D. CODIFIED LAWS § 55-2-13 (2019); 12 DEL. CODE ANN. § 3303 (2019); FLA. STAT. § 736.0306 (2018); ALASKA STAT. § 13.36.080(b) (2018); NEV. REV. STAT. § 163.004 (2019);

N.H. Rev. Stat. Ann. Section 564-B:1-105 (2018); TENN. CODE ANN. § 35-15-813 (2018).

As a practical matter, the trustee also has no control over the residency of its beneficiaries. Unlike this Court's holding in *Wayfair* and other cases addressing state taxation of business entities, the trustee cannot prohibit a beneficiary from moving from one state to another. This is in contrast to a business which may choose to not direct its business towards a state by choosing to not market and sell services or goods to residents of that state. In the case of a trust, any beneficiary can change its residency without the consent or even knowledge of a trustee. Thus, through no action of the trustee or any other beneficiary whose potential future distribution could be reduced by the taxes imposed because of the unilateral action of a single beneficiary.

Trusts with multiple generations of geographically mobile beneficiaries could easily be subject to income tax many times over, on the same dollar earned, in many jurisdictions under statutes such as North Carolina's.[21] Without carefully crafted tax credit mechanisms, this would run afoul of the internally consistent standard refined under the Commerce Clause's "fairly apportioned" rule. *Comptroller of Md. v. Wynne*, 135 S. Ct. 1787, 1809 (2015); *see also Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274

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[21] The Minnesota Attorney General may have filed a brief as amici for Petitioner, but the Minnesota trust taxation statute, Minn. Stat. § 290.01, subd. 7b (2018), is one such statute that could result in multiple taxation if applied to a trust in concert with the North Carolina Statute.

(1977). It is easy to imagine how quickly concurrent taxation may compound if three discretionary beneficiaries live in three separate states with such a statute, and each of those first-generation beneficiaries then has children who all live in different states. While discretionary beneficiaries have no identifiable interest in a trust, the interests of the beneficiaries will be harmed by diminishment of the trust assets administered by the trustee because the same dollar of income can be taxed by many jurisdictions without the appropriate credits necessary to avoid double taxation. In other words, identical application by every state would place interstate commerce at a disadvantage as compared with intrastate commerce. *See Am. Trucking Ass'ns v. Smith*, 545 U.S. 429, 437 (2005); *see also* Peter Spero, *Updated Analysis State Taxation of Out-of-State Trusts,* 46 Estate Planning 20, 25 (April 2019).

The burdens of compliance would be significant, if not insurmountable. Computation of state fiduciary income taxation is not straightforward. A trustee would need to undertake administrative responsibilities bordering on the impossible, which would make many trusts administratively unfeasible to operate.

CONCLUSION

For the foregoing reasons, the judgment of the Supreme Court of North Carolina should be affirmed.

Respectfully submitted,

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